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Repair or capitalize expenditures?*

by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, harl@iastate.edu, 515-294-6354

The line between what is a “repair” and, therefore, is deductible, and what must be capitalized and depreciated has never provided a bright line for determining how an expense should be handled. The cases have not always been consistent which is not unexpected when the facts and circumstances of each case are controlling. Two cases, one in 2000 and another in 2003 have provided useful guidance on where the line should be drawn between repairs and expenses that must be capitalized.

The regulations

The Internal Revenue Code allows taxpayers to deduct ordinary and necessary business expenses paid or incurred during the taxable year. The regulations specify that—

“The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, may be deducted as an expense.”

On the other hand, the regulation governing capitalization states that expenses are capital expenditures (and are to be depreciated) if the expenses—

“(1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) adapt property to a new or different use.”

The capitalization regulation goes on to state that—

“amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures”

As noted, whether an expense is capital is highly dependent on the particular circumstances of a given case and is ultimately a question of fact.

The 2003 case

The latest case, *FedEx Corp. & Subs. v. United States*, involved the deductibility of expenses incurred for aircraft maintenance. The court explained that whether an expense was a repair or a cost that had to be capitalized depended heavily upon what is the appropriate unit of property. Citing two earlier cases, the court in *FedEx Corp.* articulated four factors that a court should consider in identifying the appropriate unit of property to which to apply the factors from the repair regulations—

1. the court should consider whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management or accounting purposes;
2. the court should determine whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property;
3. the court should determine whether the larger unit of property and the smaller unit of property can function without each other; and
4. the court should weigh whether the component part can be and is maintained while affixed to the larger unit of property.

In the *FedEx Corp.* case, the court found that the four factors favored the entire aircraft as the separate unit of property, not the engines.

The court then proceeded to examine whether the repairs in question (involving engine scheduled visits or ESVs) were “incidental repairs” as specified by the repair regulations. The court found no support in the cases for treating “incidental” as a separate capitalization requirement under the repair regulations.

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The court next considered whether the expenditure returned the property to the state it was in before the situation prompting the expenditure arose, an expenditure intended to correct a situation, or whether the expenditure was a more permanent increment in the longevity, utility or worth of the property. The court determined that the appropriate test to apply was the corrective test, that the expenditure returned the property to the state it was in before the situation prompting the expenditure arose. Accordingly, the expenditures were all allowable as repairs.

In conclusion

The reasoning of the court in *FedEx Corp. & Subs. v. United States* and *Ingram Industries,*

Inc. & Subs. v. Commissioner is highly relevant to the question of whether a major repair on a combine or tractor engine or transmission should be considered a repair or whether the expenditure would have to be capitalized. Both cases provide useful authority for arguing that even major engine or transmission overhauls should be deductible as repairs. In general, engines and transmissions are treated as part of the larger machine, the economic life of the engine or transmission is typically considered as co-extensive with the economic life of the tractor or combine, a tractor or combine cannot function without an engine or transmission and the engine or transmission can be and generally are maintained while affixed to the tractor or combine, as the case may be.



Depreciation on listed property vehicles*

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The enactment of depreciation rules for "listed property" in 1984 marked a new era in recovering investment in business assets. For property with both business and personal use, the income tax basis for depreciation purposes is determined, as always, by applying the fraction of business use to total use. But listed property assets are further limited in terms of the amount of depreciation claimable.

The enactment of bonus depreciation rules has focused additional attention on passenger automobiles, one of the important components of listed property.

Passenger automobiles

While all vehicles used for transportation purposes are considered "listed property," automobiles and pickups of 6,000 pounds unloaded gross vehicle weight or less (GVW for trucks and vans) are subjected to dollar limits on depreciation claimable. Property must be used "predominantly" in a qualified business use in order to be eligible for the regular amount of depreciation deduction. Predomi-

nantly means more than 50 percent in a qualified business use. The proportion of a vehicle's basis that can be depreciated depends upon substantiation of business use. If the qualified business use is 50 percent or less, expense method depreciation may not be claimed, the 30 percent and 50 percent bonus depreciation allowances cannot be claimed, and depreciation deductions must be calculated using the alternative depreciation method.

In 2002, Congress passed legislation providing for a 30 percent extra depreciation allowance on new vehicles which provided specifically for an increase of \$4,600 in the first year depreciation allowance for passenger automobiles. In 2003, the Congress boosted the extra depreciation allowance to 50 percent for property acquired after May 5, 2003, and placed in service before January 1, 2005, if there was no binding con-

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